No. 01-1289

IN THE

Supreme Court of the United States

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,

Petitioner,

v.

CURTIS B. CAMPBELL AND INEZ PREECE CAMPBELL,

Respondents.

ON WRIT OF CERTIORARI TO THE UTAH SUPREME COURT

BRIEF OF KEITH N. HYLTON AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Amicus curiae will address the following question:

> Whether the Utah Supreme Court misapplied deterrence theory in its approach to reviewing the $145 million punitive damage award in this case.

TABLE OF CONTENTS

QUESTION PRESENTED i

TABLE OF AUTHORITIES iv

INTEREST OF *AMICUS CURIAE* 1

INTRODUCTION AND SUMMARY OF ARGUMENT ... 2

ARGUMENT 4

I. DETERRENCE THEORY PROVIDES USEFUL GUIDELINES FOR REVIEWING PUNITIVE DAMAGE AWARDS 5

A. The Theory of Penalties Provides the Foundation for Deterrence Theory 5

B. The Theory of Penalties Implies that Punitive Damage Awards Should Aim to Make the Injurer Pay the Full Costs of the Harm It Imposes in Some Cases, and in Other Cases the Punitive Damage Award Should Aim to Make the Injurer Disgorge Any Gains It Receives as a Result of Its Harmful Conduct 12

C. In Cases in which Punitive Damage Awards Should be Designed to Strip the Injurer of Its Gains, the Primary Concern Should be to Avoid Setting an Award that is Less Than the Minimum Necessary to Disgorge Those Gains 18

II. THERE IS NO BASIS IN DETERRENCE THEORY FOR BELIEVING THAT THE UTAH SUPREME COURT APPLIED THE THEORY IN AN IRRATIONAL MANNER 22

A. The Internalization Approach is Inappropriate for a Case Involving Fraud, and Under the Appropriate Approach, which Requires Gain-Stripping, the Utah Supreme Court's Conclusion Does Not Clearly Result in Excessive Punitive Damages or Overdeterrence 25

B. The Gain-Stripping Principle Does Imply Constraints on the Size of Punitive Damage Awards, Although Even Under Those Constraints the $145 Million Punitive Damage Award is Not Excessive 27

CONCLUSION 30

TABLE OF AUTHORITIES

CASES:

BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996) 2

Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1 (1991) 17

TXO Production Corp. v. Alliance Resources Corp., 509 U.S. 443 (1993) 8n, 20, 22n, 29n

MISCELLANEOUS:

Cesare Beccaria, On Crimes and Punishments (Henry Paolucci ed., Bobbs-Merrill 1963) (1764) 6n

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INTEREST OF *AMICUS CURIAE*[1]

Keith N. Hylton is Professor of Law at Boston University, where he teaches torts and antitrust, among other subjects. He is also Chair of the Section on Torts and Compensation Systems of the American Association of Law Schools, and Editor of the Social Science Research Network's *Torts, Product Liability, and Insurance Law Abstracts* journal. Professor Hylton has a Ph.D. in Economics from MIT, and a J.D. from Harvard University. Before moving to Boston University in 1995, Professor Hylton taught at Northwestern University Law School, where he began his teaching career in 1989. Professor Hylton has written more than forty articles in American law journals and peer-reviewed law and economics journals, many of them on the subject of tort liability. He currently serves as a member of the American Law Institute, on the Executive Board of the Antitrust Law Section of the American Association of Law Schools, and has served as a Director of the American Law and Economics Association. His textbook, *Antitrust Law: Economic Theory and Common Law Evolution*, is scheduled to be published by Cambridge University Press in November 2002.

Professors A. Mitchell Polinsky and Steven Shavell have filed an *amicus* brief in support of petitioner State Farm. The Polinsky and Shavell brief draws heavily on the argument in their article *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869 (1998). Professor Hylton responded to their article with an alternative theory of punitive damages in *Punitive Damages and the Economic Theory of Penalties*, 87 Geo. L.J. 421 (1998). Professor Hylton has

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[1] The parties have filed blanket written consents with the Clerk to the filing of *amicus* briefs in this case. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than *amicus* and his counsel made a monetary contribution to the preparation or submission of this brief.

filed this brief in order to provide the Court with a more complete view of the insights from law and economics work on punitive damages.

INTRODUCTION AND SUMMARY OF ARGUMENT

Virtually all courts accept the view that high punitive damage awards are appropriate in instances where the defendant's harmful conduct is unlikely to lead to liability. *See, e.g., BMW of N. Am. Inc. v. Gore*, 517 U.S. 559, 582 (1996). The Utah Supreme Court reinstated the $145 million punitive damage award in this case in part on the ground that "State Farm's actions, because of their clandestine nature, will be punished at most in one out of every 50,000 cases as a matter of statistical probability." Pet App. 30a. A central issue of this case is whether the Utah Supreme Court acted irrationally by misapplying deterrence theory in its review of the $145 million punitive damage award against State Farm.

Amicus contends that the Utah Supreme Court acted rationally and that its review of the $145 million award was consistent with basic deterrence principles. The theory of deterrence provides suitable guidelines for assessing the rationality and reasonableness of a punitive damage award. Deterrence theory, when correctly applied to the Utah Supreme Court's decision, does not suggest that the punitive damage award in this case should be reduced. Indeed, the $145 million punitive damage award is demonstrably within the range of reasonable awards suggested by the theory of deterrence applied to the facts of this case.

The theory of deterrence suggests two broad approaches to punishment: internalization and gain elimination. Under the internalization approach, the goal of the punishing authority is to shift all of the costs imposed on society by the offender's conduct back to the offender — i.e., to force the offender to pay

the full "social" costs of his harmful conduct. Internalization is accomplished by ensuring that the penalty imposed on the offender is equal to the total harm to society caused by his conduct. In some cases, the simplest way to do this is to divide the victim's harm by the probability of liability.

Under the gain-elimination approach, the goal of the punishing authority is to eliminate the expectation of gain from the offender's harmful conduct. Gain elimination is accomplished by ensuring that the penalty imposed on the offender is *at least as great* as the offender's realized or expected gain. In some cases, the simplest way to do this is to divide the offender's gain (or expected gain) by the probability of liability, and take the result as an estimate of the minimum gain-stripping penalty. The actual penalty imposed on the offender should be at least as large as this minimum gain-stripping level.

The most basic lesson from deterrence theory concerns when it is appropriate to use the internalization approach rather than the gain-elimination approach. The answer is simple: gain elimination is the preferable approach whenever (a) the offender has attempted to bypass the market by using force or fraud to take something from the victim, or (b) the offender's gain cannot plausibly be as great as the victim's loss. The first case applies to acts of theft and fraud. The second case applies to reckless conduct, such as speeding in a car through an area crowded with pedestrians.

In light of this basic lesson, the gain-elimination approach clearly applies to this case, which involves a corporate policy of fraudulent conduct toward consumers by State Farm. Hence, there is simply no basis in deterrence theory for believing that the $145 million award is excessive merely because the court relied on the low probability of liability associated with the overall pattern of misconduct created by the fraudulent policy.

However, there is a basis in deterrence theory for limiting punitive damage awards, and for contesting the $145 million award in this case, even when the aim of the award is, as in this case, to strip offender gains. If there is substantial uncertainty as to whether the defendant's conduct really merits the gain-stripping penalty (e.g., whether the defendant's conduct really belongs in the same category as theft and fraud), then a reviewing court should try to determine whether the punitive award exceeds the plausible range of a minimum gain-stripping penalty. If the award exceeds the plausible range of such a penalty, the reviewing court should reduce the award to the minimum gain-stripping level. The reason is to avoid imposing penalties that discourage socially benign or beneficial conduct.

Applying this rationale for limiting punitive damage awards to the case, there is still no basis for reducing the punitive damage award against State Farm. The $145 million award in this case appears to be well within the range of a plausible minimum gain-stripping award and State Farm has provided no evidence to suggest otherwise. Given this, a reviewing court should uphold the award as reasonable.

ARGUMENT

The Utah Supreme Court relied on deterrence-based arguments in upholding the $145 million punitive damage award in this case. *Amicus* will apply the theory of deterrence to evaluate the reasonableness and rationality of the Utah Supreme Court's decision. *Amicus* will begin with a summary of deterrence theory and its implications for punitive damage awards. The second part of the analysis will explore the theory's implications for the limits of punitive damage awards and the reasonableness of the award in this case. *Amicus* concludes that the theory does provide limits on the size of punitive damage awards

and that the $145 million award in this case is well within the range of a reasonable punitive damage award.

I. DETERRENCE THEORY PROVIDES USEFUL GUIDELINES FOR REVIEWING PUNITIVE DAMAGE AWARDS

A. The Theory of Penalties Provides the Foundation for Deterrence Theory

Punitive damages are designed to punish wrongdoers rather than compensate victims. The reason for punishing bad actors is to deter them from engaging in socially harmful conduct in the future. Given the importance of deterrence for the desired function of punitive damages, the proper approach to understanding deterrence theory in the context of punitive damages is to start with an examination of the theory of penalties.

The theory of penalties aims to discover "optimal" levels of penalties. An optimal penalty avoids two significant types of cost: *underdeterrence* and *overdeterrence*. Underdeterrence results when penalties are so low that they fail to deter actors from engaging in conduct that is socially harmful. Overdeterrence results when penalties are so high that they force potential injurers or offenders to take precautions that are on balance socially harmful, or to forgo engaging in socially desirable activities. For example, if the fear of tort damages (a type of penalty) for medical malpractice induces hospitals to close their emergency wards, one might view this as an example of a penalty having substantial overdeterrence costs.

The theory of penalties began with early treatments by Cesare Beccaria and Jeremy Bentham.[2] Beccaria argued that penalties should be set to eliminate the offender's gain.[3] This gain-stripping level should be viewed as the optimal level, Beccaria suggested, for two reasons. First, the gain-stripping penalty deterred harmful conduct. Second, any penalty set higher than the gain-stripping level risked encouraging more socially undesirable conduct by potential offenders. Beccaria believed that excessive and harsh penalties encouraged excessively harsh conduct from potential offenders. This may have been a reasonable assumption in his time, when torture was a common form of punishment and little effort was devoted to rehabilitating offenders.

Bentham, like Beccaria, argued that penalties should eliminate the offender's prospect of gain.[4] Although Bentham's utilitarian theories were far more wide-reaching than Beccaria's, on the particular subject matter of penalties Bentham's contributions were largely of a technical nature, though still important. Bentham stressed the role of marginal deterrence in the design of penalties and the need to increase penalties to offset any dilution in deterrence that results because the probability of punishment is low.[5] Bentham's concern for marginal deterrence — i.e., for deterring offenders from choosing the most harmful option — led him to recommend that penalties should be set sufficiently close to the gain-stripping level to avoid encouraging an offender to step up to the most harmful level of conduct.[6] For example, if the penalty for battery and murder were the same, an offender

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[2] CESARE BECCARIA, ON CRIMES AND PUNISHMENTS (Henry Paolucci ed., Bobbs-Merrill 1963)(1764); JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (Prometheus Books 1998)(1781).

[3] BECCARIA, *supra* note 2, at 43-44.

[4] BENTHAM, *supra* note 2, at 179.

[5] *Id.* at 181-84.

[6] *Id.* at 181.

who had planned to commit battery would have an incentive to murder rather than stop at the commission of the battery.

The theory of penalties remained at this stage until Gary S. Becker's contribution in 1968.[7] Becker argued that penalties should aim to internalize or to shift society's losses back to offenders — a policy which will be referred to below as the "internalization" goal. Most important, Becker set out an economic framework that generates the internalization goal, and also shows conditions under which gain-stripping would be the optimal policy. On the broader level of utilitarian theory, Becker suggested a radical neutrality or indifference toward individual preferences.[8] Gains that result from theft, under Becker's framework, are indistinguishable from gains that result from hard work and study. There is no *a priori* reason under Becker's framework for discounting the preferences of bad actors.

Becker's neutrality toward preferences has become a fundamental building block of the modern law and economics approach. However, some scholars have become so invested in this approach that they are reluctant to approve of any legal tests that allocate damages on the basis of the intent or the mental state of the offender.[9] In the place of mental state-based tests, i.e., tests that distinguish between offenders who acted innocently and offenders who acted maliciously, some scholars have advanced tests that focus exclusively on objective factors such as the

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[7] Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[8] Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 GEO.L.J. 421, 427-28 (1998).

[9] See Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657, 660 & 680 n.85 (2001) (discussing tendency in law and economics literature to de-emphasize or ignore mental state-based tests in the law, with example from torts literature).

probability of liability.[10] *Amicus* hopes to make clear that this is not at all required by the theory of penalties or deterrence theory. The economic theory of penalties, which provides the foundation for the economic theory of damages, implies that damages should depend on a characterization of the offender's conduct, which will in turn depend in many instances on a characterization of the offender's intent. The probability of liability is an important factor, but its degree of importance is heavily dependent on the appropriate characterization of the offender's conduct.

Under Becker's framework, the optimal deterrence policy depends on the relationship between the offender's gain and society's harm. If the offender's gain is always less than society's harm, then the optimal policy is to strip the offender of his expectation of gain (gain-stripping penalty). If some offenders enjoy a gain that exceeds society's loss, then the optimal policy is to internalize the loss to the offender (internalizing penalty). It happens that the internalizing penalty always performs optimally as a deterrent under this framework, and for this reason Becker urged a general policy of internalization.[11]

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[10] See, e.g., A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 910 (1998) (proposing that courts should disregard evidence on reprehensibility and determine punitive damages by dividing the compensatory damage award by the probability of liability). *Cf. TXO Prod. Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 469 (1993) (Kennedy, J., concurring) ("it was rational for the jury to place great weight on the evidence of TXO's deliberate, wrongful conduct in determining that a substantial award was required in order to serve the goals of punishment and deterrence.").

[11] To understand Becker's framework, consider an example involving intentional harms. Suppose victims own cars worth $1000 and offenders are car thieves. For simplicity, assume that each thief will be caught by law enforcers, and that the enforcement cost is zero. (If the enforcement cost is positive, then one should add the cost of enforcement to the social losses imposed by the offensive conduct.)

Of course, it should be kept in mind that the main reason Becker recommends the internalizing penalty across the board is because of its administrative ease. The internalizing penalty is administratively easy to apply because it does not require the enforcement authority to determine whether the offender's gain is less than society's loss. The administrative ease argument does not alter the underlying purpose of the penalty in the case in which offender gains are less than social losses. The underlying purpose in that case is always to completely deter offensive conduct by ensuring that no offender gains as a result of his bad conduct.

Case 1 (Low-valuing thieves): Assume first that each thief values a car at $500. Each theft therefore produces a gain of $500 to the thief. The theft also produces a loss of $1000 to the victim. The net social gain from a theft, then, is the difference between the thief's gain and society's loss, which is $500 minus $1000, or -$500. Equivalently, theft produces a net social loss of $500. (While it may seem strange to refer to a theft as producing a "gain," one must keep in mind that the Becker framework makes no distinction between the gains of thieves and the gains of ordinary people.) Since theft produces no social gain in this case, the optimal penalty seeks to prevent theft from occurring altogether. This is accomplished by a gain-stripping penalty set at a level of at least $500. Alternatively, one could choose a penalty equal to $1000 or $1 million. Any penalty sufficient to strip the offender's gains is desirable as a deterrent in this case.

Case 2 (Some high-valuing thieves): Now assume half the thieves value a car at $2000 while the other half value the car at $500. If a high-valuing thief steals a car, the net gain to society is $2000 minus $1000 = $1000. In this case full deterrence is not desirable because there is a positive net social gain when a high-valuing thief steals a car. In other words, there are overdeterrence costs when the penalty is set at a level that fully deters theft. The optimal fine under the Becker approach aims to internalize society's loss, which is set at the level $1000. This penalty completely deters theft by low-valuing offenders, and allows theft by high-valuing offenders. More generally, in the presence of uncertainty about the size of offender gains, the internalizing penalty generates the optimal level of deterrence by allowing thefts to occur whenever the offender gains more than society loses, and otherwise deterring theft.

The next important contribution to this theory was Richard Posner's *An Economic Theory of Criminal Law*.[12] The key contribution of Posner was to introduce the role of the market in the design of penalties for deterrence purposes. Posner suggested that penalties should be set at the gain-stripping level whenever the offender had the option, at low cost, of entering into a consensual transaction for whatever good or entitlement he sought from the victim. Gain stripping makes sense whenever a consensual transaction is available as an alternative because potential offenders should be encouraged, in most cases, to use the market rather than take things from victims.[13] In particular, if the transaction cost of using the market is lower than the cost of enforcing the law against an offender, then society's costs are held to the lowest level by forcing potential offenders into the market whenever con-

[12] Richard A. Posner, *An Economic Theory of Criminal Law*, 85 COLUM. L. REV. 1193 (1985).

[13] If we apply Posner's suggested approach to the car theft example in note 11, then the optimal penalty would aim to strip the gains of car thieves, whether they valued cars highly ($2000) or lowly ($500). Gain elimination is the right goal because the car thief has the option, at a presumably small cost, of approaching his intended victim and trying to arrange a consensual transaction. Thus, if the thief values the car at $2000, the penalty should be set no less than $2000; and for the low-valuing thief the penalty should be no less than $500. Administrative expenses would be minimized by setting the penalty at $2001. There is no need to worry about overdeterrence because the penalty of $2001 does not prohibit any particular transfer; it merely forces each potential thief to arrange a consensual transfer in the market. The one case in which "market forcing" may not be the best policy is when transaction costs are very high — or alternatively, the market is not a ready alternative to simply taking an item. For this reason, the framework suggests that internalization is the right policy when a consensual transaction is difficult to arrange, as in the case of a person, lost in the woods, who breaks into a cottage to steal food. The necessity doctrine of criminal and tort law embodies this exception.

sensual transactions are a relatively inexpensive means of transferring entitlements.[14]

To sum up, the theory of penalties gives us three general sets of conditions with implied penalty levels. (1) The *first* general set of conditions is where transaction costs are high (market not available) and some offender gains exceed society's losses. In this case, the optimal penalty aims to internalize society's losses. (2) The *second* general set of conditions is where transaction costs are high (market not available) and each offender's gain is less than society's loss. In this case, the optimal penalty aims to completely deter by stripping or eliminating the offender's expectation of gain. (3) The *third* general set of conditions is where transaction costs are low — in other words, the offender can easily enter into a consensual transaction with his intended victim. In this case, the optimal penalty aims to completely deter, to force actors into the market, by stripping the offender's expectation of gain.

One could just as easily reach this conclusion by carefully considering the costs of excessive penalties and the costs of inadequate penalties.[15] Whenever an honest transaction in the market is available as an alternative to simply taking something by force or fraud, penalties should be set so as to strongly

[14] See Keith N. Hylton, *The Theory of Penalties and the Economics of Criminal Law*, Boston University Law School Working Paper (2002), available at <http://www.bu.edu/law/faculty/papers>.

[15] See Hylton, *supra* note 8. An alternative approach which supports the same conclusion is found in the literature that stresses the "secondary costs" (e.g., costs of avoidance and self-protective efforts) generated by intentional misconduct. See Fred S. McChesney, *Boxed In: Economists and the Benefits from Crime*, 13 INT'L REV. L. & ECON. 225 (1993); Richard L. Hasen & Richard H. McAdams, *The Surprisingly Complex Case Against Theft*, 17 INT'L REV. L. & ECON. 367 (1997). For an application of the secondary-costs theory to punitive damages, see David D. Haddock, Fred S. McChesney, & Menahem Spiegel, *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CALIF. L. REV. 1 (1990).

encourage honest market transactions.[16] Setting the penalty higher than necessary to accomplish this purpose is not socially costly unless there is substantial uncertainty over how to characterize the offender's conduct.

B. The Theory of Penalties Implies that Punitive Damage Awards Should Aim to Make the Injurer Pay the Full Costs of the Harm It Imposes in Some Cases, and in Other Cases the Punitive Damage Award Should Aim to Make the Injurer Disgorge Any Gains It Receives as a Result of Its Harmful Conduct

The theory of penalties provides a foundation for the theory of tort damages. It has become commonplace now to think of tort damages as serving an internalizing function under the theory of deterrence. However, the framework explained above, which distinguishes between cases in which market transactions are cheap and in which offender gains exceed social losses, provides the best foundation for understanding damage awards. The framework implies precisely when punitive damage awards should be added to compensatory awards, as well as the aim of the punitive damage award.

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[16] The framework presented here is consistent with that of Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). The famous Calabresi-Melamed framework holds that property rules, which prevent violations and strip gains, are appropriate whenever transaction costs are low; and liability rules, which internalize costs, are appropriate when transaction costs are high. The framework described in the text is somewhat more complicated and incorporates the Calabresi-Melamed analysis. The connection between these approaches reveals that one function of punitive damages is to maintain the distinction between property rules and liability rules — or, equivalently, to prevent property rules from being converted into liability rules.

The internalization approach has become the common approach among tort theorists who are concerned about deterrence. However, the reason for this is that tort theorists are often trying to explain why compensatory damages should be required, and the level at which such damages should be set. If, instead, we ask what the level of damages should be, we begin to see that internalization is an approach that is appropriate in general in the torts context, but that there also exceptions in which internalization is not the best policy.

Consider the case offered in the Polinsky and Shavell *amicus* brief of

> a manufacturing plant that generates an emission that damages the finishes of automobiles in the vicinity of the plant. Damage to the automobiles is, say, $100,000, while a filter that would cost only $50,000 to install would completely prevent this damage. Because the manufacturer would rather pay $50,000 than $100,000, holding it liable for damages-equal to the harm it causes will motivate it to install the filter. This is the socially desirable outcome.[17]

This example shows that internalizing the victim's loss of $100,000 through tort damages provides optimal incentives by inducing the plant owner to install the $50,000 filter. However, if we view this as a problem of designing the right penalty, this is not the only solution. The state could impose a fine of $50,001 on the plant owner. Facing a penalty of $50,001, which would strip the plant owner of any gains from refusing to install the filter, the plant owner would have an incentive to install the filter.

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[17] Brief *Amicus Curiae* of A. Mitchell Polinsky, Steven Shavell, and the Citizens for a Sound Economy Foundation in Support of Petitioner ("Polinsky and Shavell Br.") at 7.

The manufacturing plant example forces us to ask why society should prefer, on deterrence grounds, to set damages at $100,000 (the internalizing or compensatory level) rather than at $50,001 (the minimum gain-stripping level). The answer is that in the presence of uncertainty over the cost of a filter and other options available to the plant owner, setting damages at the internalizing level generates the optimal level of deterrence. If some plant owners would have to pay $200,000 for a filter, then setting a penalty at the gain-stripping level ($200,001) would overdeter by inducing them to invest $200,000 to avoid a property loss of $100,000.

On the other hand, suppose no uncertainty existed regarding the cost of a filter, and no filter costs more than $50,000. Then there would be no basis on deterrence grounds to require the plant owner to pay damages of $100,000. The same level of deterrence could be achieved by requiring the plant owner to pay damages of $50,001, leaving the car owners to bear the remaining $49,999 in losses if the plant owner refuses to install the filter. These damages would never be realized, of course, because the plant owner would choose to install the filter.

The point of this example is to show that the deterrence goal requires us to set damages in order to internalize losses in some cases, and in other cases it requires us to set damages in order to strip gains. In order to determine whether deterrence theory implies a need for internalization as opposed to gain stripping, we need to examine the particular circumstances giving rise to the victim's injury. The three conditions identified in the preceding section give us the important features of those circumstances in terms of their implications for deterrence.

This argument's implications for punitive damages should be clear. Punitive damages are additions to compensatory damages that are designed to punish the offender in instances where such punishment is

socially desirable. The conditions identified in the previous section imply the following rules:

Punitive Rule 1: Whenever the offender has evaded the market by forcefully or fraudulently effecting a transfer of some entitlement from the victim to himself or to a third party, the offender should be forced to pay damages that, at a minimum, strip it of all expectation of gain.

Punitive Rule 2: Whenever the offender's gain is highly likely to be less than the victim's (or victims') loss, the offender should be forced to pay damages that, at a minimum, strip it of all expectation of gain.

The first punitive damage rule applies to all forms of conduct that fall under the general category of "market bypassing." Theft carried out by force or by fraud are classic examples. With respect to all such conduct, the appropriate aim of the court in evaluating a punitive damage award is to completely deter or eradicate the conduct by eliminating any prospect of gain on the part of the defendant.

The second punitive damage rule applies to conduct in which the gain to the offender is obviously less than the loss imposed on others. The classic case here is reckless conduct: for example, driving at a high speed through an area crowded with pedestrians. On the assumption that the offender does not have a necessity-based defense (e.g., that he had to speed in order to save another life), and that he is not directly aiming to run someone over (which would change the example to intentional murder), this is a case in which the risks imposed on others cannot be justified by the gain to the actor. Another example is allowing a young child to drive a car in an area with pedestrians or other cars, or to play with a gun in such an area. Again, in this case, it is highly unlikely that the offender's gain could justify the risk of loss imposed on others. In these cases, the actor's conduct should be completely deterred. It follows that a punitive damage award should aim, at a minimum, to remove

any prospect of gain from the injurer, and it may often be appropriate to set the award considerably higher in order to discourage other potential offenders.

It remains to be explained where the internalization approach recently urged by Polinsky and Shavell fits within this framework.[18] Polinsky and Shavell have argued that punitive damages should be determined by dividing the actual loss by the probability of liability.[19] By dividing the compensatory portion by the probability of liability, the total award effectively makes the offender pay for all of the costs it imposes on society — because each award forces the offender to pay for those cases in which it "gets away" without being held liable for its conduct. The punitive portion of the award, under this algorithm, is simply the difference between this measure and the compensatory measure. In a regime in which liability is uncertain, the Polinsky and Shavell algorithm guarantees full internalization of victim losses.

It should be clear from the foregoing that the internalization rule urged by Polinsky and Shavell should be followed when the offender has not evaded the market (i.e., a market transaction is difficult to arrange, as in most accident settings) and the offender's gain is likely to be greater than society's loss. Most run-of-the-mill torts involving accidental or non-intentional injuries fall within this category. For example, the competent operation of a railroad is an activity in which the operator's gain (as well as the gain to customers) is likely to exceed losses due to accidents. Moreover, a pre-accident market transaction in which the railroad and the victim agree on an allocation of the accident risk is infeasible. Internalization is the proper goal in this context, since society has no interest in completely deterring the competent provision of rail service. Given that internalization is the appropriate goal under deterrence theory, damage

[18] Polinsky & Shavell, *supra* note 10.

[19] *Id.* at 874-75.

awards involving accidental injuries should never exceed the actual loss divided by the probability of liability.[20]

A more straightforward example in which the Polinsky and Shavell approach is properly applicable is the case in which an employee of a firm steals from a customer, against the firm's policies and interests, while acting within the scope of employment. Consider, for example, an insurance agent who steals customers' premium payments rather than remitting them to the insurer, as in *Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1 (1991). Since the employee has committed a theft, any damage award against the employee alone should aim, at a minimum, to strip the employee's gain. The damage award against the employer, however, should be limited by the internalization principle. The reason is that the employer itself has not adopted a policy of theft, and indeed the employer itself suffers a loss in this case. In order to provide the right incentives for the employer to monitor its employees (or, in some cases, agents) it may be necessary to divide the customer's actual loss by the probability of liability.

[20] As it happens, courts typically award compensatory damages, without any upward adjustment based on the probability of liability. Even though courts do not typically inflate damages by dividing by the probability of liability, this does not imply that ordinary tort law fails to appropriately deter harmful conduct. For a careful explanation, see Richard Craswell, *Deterrence and Damages: The Multiplier Principle*, 97 MICH. L. REV. 2185 (1999). Indeed, since ordinary negligence rules do not seem to be insufficient to deter harmful conduct, inflating damages by dividing the compensatory award by the probability of liability (in routine cases of negligence) could easily result in socially excessive deterrence. See Mark F. Grady, *Efficient Negligence*, 87 GEO. L.J. 397 (1998). In view of this, the Polinsky and Shavell algorithm should be understood as *providing an upper limit* on damages in which liability is based on negligence or some strict liability doctrine (e.g., nuisance).

C. In Cases in Which Punitive Damage Awards Should be Designed to Strip the Injurer of Its Gains, the Primary Concern Should be to Avoid Setting an Award that is Less Than the Minimum Necessary to Disgorge Those Gains

In cases where it is appropriate under deterrence theory to eliminate the injurer's gain, the primary concern of the penalty designer should be to make sure that the penalty is not so low that it fails to deter harmful conduct. Overdeterrence is not a concern because the reason for gain stripping is to totally deter or eradicate the injurer's conduct, not to constrain it to some "optimal" level. In this part, *amicus* shows the implications of this argument for the proper consideration of the likelihood of liability in the design of an optimal penalty.

As a general rule, the probability of liability plays the same role in the design of a gain-stripping damage award that it plays in the design of an internalizing damage award. According to Polinsky and Shavell, a court should divide the damage award by the probability of liability in order to internalize the full amount.[21] In the gain-stripping case, the same rule applies. In order to ensure that offender gains will be stripped, the award must be no less than the offender's gain divided by the probability of liability.

However, deterrence theory implies that the probability of liability has only a secondary level of importance in the determination of a gain-stripping punitive damage award. When the offender's conduct is "market bypassing" (Punitive Rule 1), the proper goal of deterrence is to completely deter the offender's conduct. Given the goal of complete eradication or deterrence, there is no reason on deterrence grounds to worry about costs due to excessive deterrence. This implies that a mistake in the direction of assuming an

[21] Polinsky & Shavell, *supra* note 10.

inaccurately low probability of liability is unlikely to generate significant overdeterrence costs, provided that the offender's conduct definitely belongs in the market-bypassing category. The same goes for the case in which the offender's conduct definitely belongs in the gain-less-than-loss category (Punitive Rule 2).

The key difference between gain stripping and internalization as goals of the punitive damage award lies in their implications for overdeterrence costs. In the case in which internalization is the proper goal, the court must divide by an accurate measure of the probability of liability in order to avoid generating overdeterrence or underdetterence costs. In the case in which gain-stripping is the proper goal of the damage award, the most important goal in estimating the probability of liability is to avoid choosing an inaccurately large estimate of the probability of liability. Since underdeterrence is a far more important concern than overdeterrence in this case, courts should aim primarily to avoid making a mistake in the direction of setting the penalty below the minimum necessary to strip the gain generated by the offender's conduct.[22]

The following example allows one to apply these lessons to the case of an offender who engages in a multi-part scheme of misconduct. Suppose the offender engages in two types of intentional harmful conduct with different probabilities of liability con-

[22] Note that this greatly eases the administrative burden of trying to take the probability of liability into account in determining a multiplier for a punitive award. In most cases it is almost impossible to get an accurate estimate of the probability of liability. The gain-stripping approach, which stresses avoidance of underdeterrence, is considerably easier to apply than the internalization approach because it only requires the court to find a lower bound on the range of plausible estimates of the probability of liability. The internalization approach of Polinsky and Shavell requires the court to find an exact estimate of the probability of liability.

nected to them. To take a simple case, assume the offender steals cars in the middle of the night, and also steals credit cards, doing both with equal frequency. The offender's gain from stealing cars is $2000 per car and from stealing credit cards is $5000 per card. Suppose the likelihood of being caught is 1/10 for car theft, and 1/2 for credit-card theft. The minimum gain-stripping penalty for car theft is $20,000 ($2000 divided by 10), and $10,000 ($5000 divided by 1/2) for credit card theft. In other words, the minimum gain-stripping multiplier is 10 for car theft and 2 for credit-card theft (and these multipliers are applied to the offender's gain in each case).

Now suppose the court uses the lowest probability of liability in order to calculate the multiplier. In this case, the court would apply the minimum car-theft multiplier of 10 in every case involving the defendants who took part in the car and credit card theft scheme. Does this result in substantial overdeterrence costs? No. The defendant's theft operation yields no social benefits whatsoever. It should be completely deterred. Alternatively, the court could impose the average of the two gain-stripping awards ($10,000 and $20,000) in all cases, resulting in the imposition of a damage award of $15,000 in each case. Since this approach strips illicit gains on average (though just barely), it is equivalent on average to the approach that uses the correct offense-specific multiplier for each type of misconduct. The important goal for the punishing authority is not to determine accurate offense-specific multipliers for each type of misconduct. The important goal is to determine penalty levels that are sufficient to eliminate the offender's illicit gain.

TXO Production Corp. v. Alliance Resources Corp., 509 U.S. 443 (1993), provides a good illustration of the theory described so far. Geologists employed by TXO determined that recovery of oil and gas under a roughly 1000 acre tract of land knows as the

"Blevins Tract" would be profitable. They recommended that the company acquire the rights to develop the oil and gas under the tract. The owner of those rights was Alliance Resources Corporation. TXO made an offer that Alliance considered "phenomenal," which suggests TXO put a higher value on the resource than did Alliance (i.e., offender's gain exceeds victim's loss). Alliance accepted the offer, assigned its interest in the Blevins Tract to TXO, and agreed to return the consideration paid to it if TXO determined that the title had failed.

TXO immediately set about on a series of fraudulent efforts to show that the title had failed. Eventually, TXO sent a letter to Alliance informing it of a title objection and suggesting that TXO had acquired the oil and gas development rights from another source. TXO filed for a declaratory judgment on the conflicting ownership claims. The jury found in favor of Alliance's counterclaim for slander of title and awarded Alliance $19,000 in compensatory damages and $10 million in punitive damages.

The probability-of-liability approach urged by Polinsky and Shavell would require the court to divide Alliance's loss, $19,000, by the probability TXO would be held liable. The probability that TXO would be held liable is the product of the probability that Alliance would file suit and the probability that the court would find in favor of Alliance. Since both probabilities were high, the Polinsky and Shavell approach suggests that the optimal punitive damage award is TXO would have been zero. TXO's damages would have been limited to $19,000.

The framework described here, which follows the general implications of deterrence theory, suggests that the punitive damage award should have been no less than the amount awarded, $10 million. A $10 million punitive damage award appears to be quite close to the minimum necessary to eliminate the expected gain from TXO's fraudulent conduct. The

figures on amounts invested suggest that TXO could have anticipated a profit on the order of $9 million from its expropriation of Alliance's development rights.[23] Since the probability of liability was high in this case, there is no clear need to boost the judgment substantially to make up for the risk of non-liability. On the other hand, since TXO's conduct clearly fell within the market-bypassing category (Punitive Rule 1), courts should be far more concerned about under-deterrence costs than about overdeterrence costs. The punitive damage award of $10 million does not appear to be in any way excessive under this approach.

II. THERE IS NO BASIS IN DETERRENCE THEORY FOR BELIEVING THAT THE UTAH SUPREME COURT APPLIED THE THEORY IN AN IRRATIONAL MANNER

In part based on plaintiffs' evidence that "State Farm's actions, because of their clandestine nature, will be punished at most in one out of every 50,000 cases as a matter of statistical probability," Pet. App. 30a, the Utah Supreme Court upheld the $145 million punitive damages verdict in this case. The Polinsky and Shavell *amicus* brief argues that the court's reasoning was flawed because in determining the probability that State Farm's actions would escape liability,

> the court failed to focus on the specific form of misconduct engaged in by State Farm in the present case — the unreasonable rejection of a settlement offer in a case against one of its insureds — and

[23] Hylton, *supra* note 8, at 452. *See also TXO*, 509 U.S. at 447, 450-51 n. 10 (plurality opinion of Stevens, J., joined by Rehnquist, C.J., and Blackmun and Kennedy, J.J.) (suggesting possible value of the expected gain as high as $8.25 million — i.e., respondents' 22% royalty interest in an expected income stream worth up to $37.5 million).

> instead focused on a much more diverse range of alleged wrongs, including purported underpayment of first-party claims by State Farm. Because these discrete forms of misconduct involve different likelihoods of generating liability, there is no foundation in deterrence theory for the court's conclusion that a very high ratio between punitive damages and compensatory damages was warranted in this case.[24]

Polinsky and Shavell conclude that

> The court's analysis almost certainly caused it to significantly overestimate the likelihood that State Farm would escape liability for unreasonable rejection of settlement offers — and thus to overstate the size of the punitive award necessary to deter such behavior. Its judgment, if affirmed, would likely generate the adverse consequences associated with excessive damages awards.[25]

Polinsky and Shavell may or may not be right when they say that the court's analysis embodies a significant overestimation of the probability that State Farm would escape liability for unreasonable rejection of settlement offers. However, their suggestion that the punitive damage award in this case is excessive on that basis is unwarranted.

First the internalization approach urged by Polinsky and Shavell is entirely inappropriate for a case such as this involving an intentional tort carried out by force or fraud, or other indisputably reprehensible conduct. Although Polinsky and Shavell describe State Farm's conduct as evidencing unreasonable,

[24] Polinsky and Shavell Br. at 14-15.
[25] *Id.* at 15.

bad-faith claim handling,[26] the Utah Supreme Court upheld the trial court's finding that State Farm's conduct was fraudulent. See p. 30, *infra*.[27] Since fraud is a classic form of market-bypassing conduct, deterrence theory does not imply a sharp limit on the punitive damage award. Indeed, Polinsky and Shavell have conceded that internalization is inappropriate for a case such as this. In their article on punitive damages they note that

> [i]f . . . a reprehensible act is purely intentional, overdeterrence cannot occur. Suppose a surgeon intentionally left a surgical tool in the patient . . . . Threatening the surgeon with punitive damages would further discourage the surgeon from intentionally leaving the surgical tool in a patient. Overdeterrence cannot occur.[28]

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[26] Polinsky and Shavell Br. at 3 (case involves "State Farm's unreasonable rejection of an offer by a third-party to settle a suit against" Campbell); *id.* at 6 ("the unreasonable refusal to settle third-party claims against its insureds" is "the conduct for which the company was found liable in this case").

[27] Specifically, the Utah Supreme Court held that "State Farm repeatedly deceived and cheated its customers" pursuant to an official policy of setting "monthly payment caps" on payouts by adjusters and "individually reward[ing] those insurance adjusters who paid less than the market value for claims," Pet. App. 18a — conduct that it described as "reprehensible." Pet App. 20a. Further, the court emphasized that "State Farm's fraudulent conduct has been a consistent way of doing business for the last twenty years, directed at some of society's most vulnerable groups." Pet. App. 34a. State Farm's fraudulent incentive pay policy, the trial court held, "has applied equally to the handling of both third-party and first-party claims." Pet. App. 119a. In affirming the trial court, far from basing its decision on a "bad faith" theory, the Utah Supreme Court indicated that it saw no need to address the theory because the entirety of the jury's verdict was sustainable on the fraud count. Pet. App. 60a, 64a.

[28] Polinsky & Shavell, *supra* note 10, at 907 n.120.

In addition, the facts of this case suggest that the punitive damage award of $145 million may well be below the minimum necessary to strip State Farm of its gains. Thus, there is no reasonable basis suggested in the record for rejecting the award as excessive. Where a defendant has not proffered evidence to provide such a basis in the record, a reviewing court should not accept its assertions that it has been punished excessively.

A. The Internalization Approach is Inappropriate for a Case Involving Fraud, and Under the Appropriate Approach, Which Requires Gain-Stripping, the Utah Supreme Court's Conclusion Does Not Clearly Result in Excessive Punitive Damages or Overdeterrence

Perhaps the most important lesson from deterrence theory is that the proper measure of damages is dependent on the characterization of the offender's conduct. If the offender's conduct appears to be a type of theft (or more generally, market bypassing), then deterrence theory implies that the punitive damage award should aim to eliminate the offender's expectation of gain. In describing State Farm's misconduct, the trial court found that it had put in place "an unlawful scheme to provide undisclosed incentives to adjusters to deny benefits owed consumers by paying out less than fair value in order to meet preset, arbitrary payout targets." Pet. App. 118a-119a. It termed this misconduct "callous, clandestine, fraudulent, and dishonest." Pet. App. 136a. Commenting on "the scale of the fraud," the trial court held that "State Farm's claim-handling practices are predicated on exploiting the trust placed in it by its policyholders." Pet. App. 138a-139a. State Farm's misconduct in this case should therefore be completely deterred through the imposition of a gain-eliminating damage award.

There are no significant overdeterrence costs because a high punitive damage award merely encourages insurance firms not to adopt claims-processing policies that are generally regarded as "predatory," "inherently fraudulent," and "simply taboo in the insurance industry." Pet. App. 118a.[29]

Further, under the gain-elimination approach, the court need not worry about overdeterrence, because the whole aim of the punishment is to completely eradicate the offender's conduct — to set its frequency at zero. Thus, in order to determine whether a punitive damage award satisfies the gain-elimination standard, two things need to be determined. First, what was the offender's gain? Second, what was the probability of liability? The minimum gain-eliminating penalty is found by dividing the offender's anticipated (or realized) gain by the probability of liability.

If one applies the gain-stripping rule to this case, the $145 million punitive verdict cannot be regarded as excessive on deterrence grounds, provided that the defendant's conduct is truly fraudulent. The key aim is to make sure that the award is no smaller than the minimum necessary to eliminate the possibility of gain on State Farm's part. The primary concern under the gain-stripping approach is to avoid underdeterrence.

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[29] The risk of overdeterrence is even less in a case like this where the existence of a company's "conscious policy of fraudulently denying its customers the benefits of their contracts" is proven not by circumstantial evidence of a pattern of activity, but "with direct evidence, in the form of internal company documents, admissions from a number of former employees, and expert witnesses." Pet. App. 137a.

B. The Gain-Stripping Principle Does Imply Constraints on the Size of Punitive Damage Awards, Although Even Under Those Constraints the $145 Million Punitive Damage Award is Not Excessive

Although the gain-stripping approach does not imply a limit on punitive damage awards for fraud, theft, and other types of market-bypassing conduct, it may still be worthwhile under this approach to try to determine the minimum award necessary to eliminate the defendant's gains. There are two reasons for this. First, we should determine the minimum in order to make sure that the punitive damage award really does exceed the minimum. Second, if there is any possibility of error in the court's characterization of the defendant's conduct, we should try to determine whether there is a risk of serious overdeterrence, which could arise only if the court has erroneously characterized the defendant's conduct.

There are three approaches one could take to determine the minimum gain-stripping penalty in this case. The first is to determine the expected gain from each type of intentional misconduct (assuming relevant variations exist), and to divide that sum by the probability that the defendant would be held liable for that particular variation of misconduct. The second approach is to determine the average gain from the defendant's intentional misconduct and multiply that sum by the factor necessary to eliminate the defendant's average gain. The third approach is to determine the total gain from the defendant's intentional misconduct, and to simply use that sum as the estimate of the punitive verdict. All three of these approaches should have the same result in the long term — eliminating the offender's illicit gains.

The third approach is easiest to apply here, given that State Farm has provided no evidence that would require a court to conclude that the punitive

damage award in this case exceeds the profits State Farm pocketed from its misconduct. State Farm's fraudulent payout-capping scheme ran from 1979[30] to at least the time of the Campbells' trial in 1996. Pet. App. 23a. It was described by the trial court as "extremely profitable." Pet. App. 140a. If State Farm's scheme netted the firm as little as $10 million per year, then its gain would have amounted to at least $160 million, ignoring the returns from investing the early proceeds.[31] The punitive damage award in this case is less than this conservative estimate of State Farm's illicit gain.

The upshot of this exercise is a general method for reviewing the reasonableness of a punitive damage award, and a specific conclusion as to the reasonableness of the $145 million punitive damage award in this case. The general method of review suggested here would decide the reasonableness of a punitive damage award, on deterrence grounds, by asking whether a plausible construction of the facts could yield the punitive damage award as a minimum gain-stripping penalty. If, in light of the facts of the case, the punitive damage award appears to be within the range of plausible minimum gain-stripping penalties, then the punitive damage award should be deemed reasonable.[32] If the punitive damage award is clearly

[30] Pet. App. 132a (describing date of State Farm's PP&R manual).

[31] If we add the returns from investing proceeds from early years, then State Farm's probable gain increases dramatically. For example, if State Farm earned six percent per year from investing $10 million of illicit gains annually, the total over the period 1979 to 1996 would come to about $280 million.

[32] Potential defendants might object to this approach on the ground that it could lead to an excessive award — i.e., an award that exceeds any realistic estimate of the defendant's illicit gain. However, defendants always have the option to provide evidence to prove that their gains from an illicit scheme were less than a certain amount, in order to cap the punitive award. For example, in this case State Farm could have provided evidence that its annual gain from its payout-capping scheme (specifically,

above the range of plausible minimum-gain-stripping penalties, then a reviewing court should uphold the award only if there is little uncertainty regarding the maliciousness of the defendant's conduct.

For example, suppose a defendant, in order to gain $100, fires a gun indiscriminately into a crowd of people. Since there is absolutely no uncertainty regarding the maliciousness of the defendant's conduct, no court should consider itself bound by law to constrain the punitive portion of the judgment to a limit of $100. Since complete deterrence is the proper goal, and since there is no uncertainty regarding the inherent offensiveness of the defendant's conduct, a court should consider itself free to assess a punitive damage award at any level above $100. On what basis would a court ever *limit* the punitive award in this example? What overdeterrence costs would a court be trying to avoid?

On the other hand, in the business context there are cases in which there is uncertainty regarding the proper characterization of the defendant's conduct.[33] Many such cases are decided by a jury, and once a jury has decided that the defendant's conduct is malicious, the matter is settled. Unless the facts are such that no reasonable jury could have found the defendant's conduct malicious, the jury's determina-

the fraudulent parts of it) amounted to a relatively small amount, say $1 million. Over the sixteen year period of State Farm's wrongdoing, that would mean a total of $16 million in illicit profits, compared with a punitive damage award of $145 million, nine times the illicit gain, which State Farm could then argue have argued was excessive. *But see TXO*, 509 U.S. at 446, 462 (plurality opinion of Stevens, J., joined by Rehnquist, CJ, and Blackmun, J.)(upholding punitive damage award of $10 million even on assumption that the expected gain was only $1 million).

[33] For example, in the field of antitrust, a finding of "intent to monopolize" is always clouded to some extent by the defendant's natural desire to maximize profits. For this reason, commentators and courts have found it difficult to articulate a legal test for monopolization that avoids punishing firms for aggressive pro-competitive conduct, see Cass & Hylton, *supra* note 9.

tion has to stand. Still, even in such a case, a reviewing court may have some lingering doubts as to whether the defendant's conduct should have been labeled malicious. Under the theory presented here the appellate court should have broad authority to review the reasonableness of the trial court's punitive damage award. The basis on which such a review should be conducted is to determine whether the award is within or well beyond the range of plausible minimum gain-stripping penalties. If the award is well above the range of such penalties, then the reviewing court should require the trial court to set the award at the minimum gain-stripping level, at least where there is legitimate doubt about whether the offender's conduct is clearly wrong.

The $145 million punitive award in this case appears to be well within the range of reasonable awards. The trial court and the Utah Supreme Court concluded that State Farm, as a matter of official corporate policy, pursued for nearly two decades a fraudulent incentive scheme to underpay claims, that the Campbells were among its many victims, and that it remained in effect at the time of trial. Pet. App. 18a, 20a, 34a, 118a-119a-121a, 134a-136a, 138a-141a. There is a plausible construction of the underlying facts that yields $145 million as the minimum gain-stripping penalty. Indeed, the $145 million punitive damage award may well be less than the minimum amount necessary to eliminate State Farm's illicit gains. Given this, there is no basis on deterrence grounds for holding that the punitive damage award was excessive.

CONCLUSION

The judgment of the Utah Supreme Court should be affirmed.

Respectfully submitted,

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